Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:2:[redacted]:Posts-132989-02
[redacted]

date: August 22, 2002

to: SBSE Territory Managers - [redacted]

from: Associate Area Counsel
(Small Business/Self-Employed:Area 2)

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subject: **Theft Loss in Offshore Credit Card Cases**

This memorandum responds to your request for assistance dated June 11, 2002. This memorandum should only be used in relation to the taxpayers that invested in the investment group set forth below and should not otherwise be cited as precedent.

ISSUES

1. Whether the investors in [redacted] LLC are entitled to a theft loss?

2. If the investors are entitled to a theft loss, in what year would the investors be entitled to the loss. (We will not address the amount of the loss for the investors as this may differ dramatically based upon the facts of each case.)

CONCLUSION

1. While the losses by nature are theft losses under I.R.C. § 165(c)(3), the deduction may not be allowable in some cases based upon public policy grounds. The allowance of a theft loss will depend upon the specific facts of each case.

2. As of the date of this memorandum, the taxpayers/ investors still have a reasonable prospect of recovery of some or all of their investment. Thus, no deduction is currently allowable.

FACTS

During the [redacted] and [redacted] taxable years, an investment scheme involving offshore credit cards was being promoted in several states, including [redacted]. The investment company was [redacted], (hereinafter [redacted]) and the promoters were [redacted] (hereinafter [redacted]) and [redacted]

[redacted] (hereinafter [redacted]; [redacted] resides in [redacted]). Investors were sold a limited partnership interest in which they were to receive a [redacted] percent [redacted] return on their investment. Investors had the option of reinvesting the interest earned or have it paid to a credit card account the investor opened with a bank in [redacted]. The investment scheme began in [redacted] or [redacted]. Many taxpayers/investors that invested in the beginning did receive some return on their funds which in turn was reinvested. Most of these payments were paid with the investments of others, i.e., a pyramid or [redacted]. Many of the taxpayers/investors that got in on the scheme in [redacted] did not receive any payments. Thus far we know of only one taxpayer who recouped all of their investment although we do understand that there were some facilitators that were paid for bringing in other investors.

In September of [redacted], [redacted] was arrested for defrauding approximately [redacted] people nationwide out of $[redacted] over an [redacted] period. [redacted] of these investors are [redacted]. [redacted] is suspected of spending at least $[redacted] on his [redacted], his new [redacted] and other assets. [redacted] monetary transactions. Nevertheless, in [redacted], the [redacted]. Accordingly, in [redacted], the [redacted] filed a civil suit against [redacted], [redacted] and [redacted] for [redacted]. A copy of the Litigation Release from the [redacted] website is attached. As of the date of this memorandum, the [redacted] civil action has not been concluded. We have no information as to whether any of the individual investors/taxpayers have filed civil suits against the promoters or [redacted]. [redacted]

DISCUSSION

Issue 1

Section 165(a) provides that there will be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c)(3) provides for a deduction for a theft loss.

Whether a loss from theft has occurred depends upon the law of the jurisdiction where it was sustained. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); Monteleone v. Commissioner, 34 T.C. 688, 692 (1960). The law in both [redacted] and [redacted] provides that obtaining property and funds by false pretenses is a crime. [redacted];

[redacted]. Thus, under the law for [redacted], and based upon the facts set forth herein, it would appear that there has been a misappropriation of funds or a theft of the taxpayer/investor funds invested in [redacted]. See contra McCullough v. Commissioner, T.C. Memo. 1990-653, where the Tax Court found that there was no proof of a theft loss from the taxpayers' investment in an offshore "double trust" scheme. (In cases in states other than [redacted], a determination will have to be made as to whether a theft occurred under state law in order to determine whether a loss would be allowable.) Thus, technically the taxpayers/investors may be entitled to a theft loss if they can prove that they had a loss, the amount of the loss and the year that the loss should be deducted.

With regard to the allowance of a theft loss, we understand that there are some divergent views on whether the taxpayers involved in [redacted] should be allowed a loss at all. There is some authority for not allowing a theft loss at any time to taxpayers who may have purposefully engaged in tax avoidance activities and/or fraudulent schemes. See Richey v. Commissioner, 33 T.C. 272 (1959); Lincoln v. Commissioner, T.C. Memo. 1985-300. Accordingly, consideration should be given to disallowing a theft loss deduction in cases where there is evidence that the taxpayer knew the purpose of the scheme was tax avoidance, there is evidence of unreported income, and/or the taxpayer/facilitator invested little of his own money but duped others into investing, thereby profiting from the facilitation of the activity.

We are aware that there are cases currently in inventory where taxpayers and even facilitators were scammed, were not engaged in tax avoidance, and did not have unreported income. In these cases, the loss could be allowable. Thus, barring specific facts that a particular taxpayer knew the scheme was being used for tax avoidance, the taxpayer would be entitled to a theft loss if they can substantiate the loss. See e.g. Berardo v. Commissioner, T.C. Memo. 1987-433.

Issue 2

Section 165(e) provides that any loss arising from a theft loss shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.[1] The loss from each

[1]Section 165(c)(2) provides for a deduction for losses incurred in any transaction entered into for profit, though not connected with a trade or business. Nevertheless, based upon the

theft must exceed $100.00 and the aggregate losses for a taxable year must exceed 10 percent of the taxpayer's adjusted gross income. I.R.C. § 165(h)(1) and (2). The year of discovery is based upon a "reasonable person" standard. That is, the year of discovery is the year in which a reasonable person in similar circumstances would have discovered the theft loss. See Cramer v. Commissioner, 55 T.C. 1125, 1133 (1971), acq., 1971-2 C.B. 2.

It is important to understand the distinction between discovering the theft and discovering the loss. The statute refers to the discovery of the loss, not the theft. Rainbow Inn, Inc. v. Commissioner, 433 F.2d 640, 642 (3d Cir. 1970); Lapin v. Commissioner, T.C. Memo. 1990-343, aff'd. without opinion, 956 F.2d 1167 (9th Cir. 1992). This means that the taxpayer must show more than just the discovery of a theft. The taxpayer must show "the discovery of a loss for which it can be ascertained with reasonable certainty whether or not such reimbursement will be received." Treas. Reg. § 1.165-1(d)(3); Premji v. Commissioner, T.C. Memo. 1996-304, aff'd. 98-1 USTC ¶ 50218 (10th Cir. 1998). Accordingly, a deduction for a theft loss will be barred in a year in which a reasonable prospect of recovery exists. Treas. Reg. § 1.165-1(d)(3). There is no requirement that there be an absolute certainty of no recovery.

In the present case, one of the promoters of [redacted], [redacted], was charged in [redacted] with mail fraud, wire fraud, money laundering and fraudulent monetary transactions. We located [redacted]. Thus, an argument could be made by investors in that area that the year of discovery of the theft would be [redacted][2]. Nevertheless, [redacted] had investors from all over the nation, and we have no way of knowing at this point whether a [redacted] article in a [redacted] put them on notice that there may be a problem with their investments. Moreover, it was not until [redacted] that the [redacted] filed suit against both promoters for fraud and misleading investors and that the taxpayers/investors were contacted by [redacted]. The taxpayer/investor may present evidence that he discovered the theft prior to [redacted], for example, correspondence with an accountant, an email to a fellow investor, etc. Nevertheless, discovery of the theft is not enough.

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facts set forth above, section 165(c)(3) would be the applicable section.

[2]It is interesting to note that to our knowledge none of the taxpayers/investors under examination claimed a theft loss in [redacted] or any other year.

The taxpayer/investor must show a theft loss. A theft loss is generally deductible in the year "sustained" and a sustained loss must be evidenced by a closed and completed transaction. I.R.C. § 165(a); Treas. Reg. § 1.165-1(d)(1); Boehm v. Commissioner, 326 U.S. 287, 291 (1945). A transaction is not closed if in the year of the alleged loss, the taxpayer has a claim for reimbursement that provides a reasonable prospect of recovery. Ramsay Scarlett and Company v. Commissioner, 61 T.C. 795, 808 (1974), aff'd. 521 F.2d 786 (4th Cir. 1975).

As of the date of this memorandum, it would appear that a reasonable prospect of recovery still exists with respect to the assets of [redacted].[3] First, the [redacted] has obtained a disgorgement order from [redacted] but no accounting of his assets has been received so there is no way of knowing at this point if there are any assets from which to repay investors and, if so, the extent to which they would be repaid. Second, with regard to [redacted], he recently filed his answer in the civil suit with the [redacted] so a determination of assets with regard to his case cannot be made at this time. [redacted]

Based upon the [redacted] civil suit with the [redacted] and the [redacted], no definitive determination of an amount of loss can be made, and a reasonable prospect of at least some recovery exists, thereby barring a deduction at this time. Accordingly, no theft loss should be allowed for the [redacted], [redacted], [redacted] or [redacted] taxable years.

[3]To our knowledge none of the taxpayer/investors under examination have filed individual civil suits against [redacted], [redacted], or [redacted] in an attempt to recoup their funds.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions, please contact the undersigned at [redacted].

[redacted]
Senior Attorney (SBSE)

APPROVED:

[redacted]
Associate Area Counsel (SBSE)

Attachment:
[redacted]